CALL RATES AND THE FEDERAL RESERVE BOARD

The framers of the Federal Reserve act changed the old system of reserves for the national banks which had encouraged the concentration of funds in New York and their utilization for call loans on the Stock Exchange. They attempted to restrict, as far as possible, the use of the facilities of the federal reserve banks to those engaged in commerce, agriculture, and manufactures as distinct from speculation. The act provides (sec. 13):

> Any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is . . . issued or drawn for agricultural, industrial, or commercial purposes. . . . Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States.

It will be noted that the facilities of the federal reserve banks would be available for those who wished to borrow on security of agricultural products or merchandise. Thus the speculator in wheat or cotton might borrow from a member bank and the member bank might rediscount the note at the federal reserve bank. However, notes of those who borrowed for speculation in stocks could not be rediscounted unless based on government securities.

We cannot know how these new regulations would have affected call rates if the war had not come to complicate matters by introducing new problems of government finance into the situation. The federal reserve system, by lowering the reserve requirements of the banks and by the system of rediscounts, made possible an expansion of banking facilities. In the early years of the war our advantageous position as a supplier of food and munitions brought to us about $1,000,000,000 of gold imports. When we entered the war the Treasury Department determined to utilize some of the expansion of banking facilities made possible by the lessened reserve requirements and the great stock of gold for the purpose of financing the government directly or for the purpose of easing the money market to facilitate the flotation of the government bonds.

The Treasury did not wish to have the supply of bank funds diverted to speculation, so in October, 1917, a money pool was

created in New York. The banks furnished the money, kept the rate about 6 per cent, and held the volume of loans to an aggregate of about $500,000,000.[1] The pool lasted until January, 1919. At that time, the officials of the New York Exchange wrote to the Money Committee: ". . . there is now nothing to indicate the probability of a speculative movement which would absorb large amounts of money."[2] After consultation with the Treasury, therefore, the committee gave up control.

The events which followed showed that the officials of the Stock Exchange were poor prophets. Starting in February, 1919, the prices of stocks went up steadily with the exception of a minor reverse in June and more severe ones in August and November. The amount of loans on the Stock Exchange was estimated as over $1,000,000,000 by May,[3] as about $1,500,000,000 from July through October,[4] and as $1,350,000,000 early in December.[5]

The situation suggests the following problem. Suppose that there is a period of activity on the Stock Exchange and the rates on call loans are attractive; suppose the Federal Reserve Board thinks that the funds of the banks should not be used for speculation. Can the board with its present powers make effective its wish? Can the law, by the use of discriminating provisions for the rediscount of commercial paper, keep the banks from entering a profitable line of business? The problem is doubly interesting. It is interesting to see what the Federal Reserve Board can do and it is interesting to see what the attitude of the bankers will be toward the guidance of the board. Up to this time, all of the efforts of the board had fallen in line with the wishes of the bankers. They applauded the board's activities which had eased the strain in the money market caused by the government war financing. The inflation made possible increased lending on the part of the banks. But not so in the present case; here is an attempt to cut down the amount of loans to be made; to limit possible earnings in order that the vague general welfare may be furthered. From the standpoint of the self interest of the banks the situation appears simple. Call loans on stock exchange security are liquid in ordinary times; the rate is not restricted by law. If the chance comes, with an active market, to make large loans at

1 *Annalist,* June 9, 1919, p. 573.

2 *Commercial and Financial Chronicle,* vol. 108, pp. 423-24.

3 *Wall Street Journal,* May 27, 1919.

4 *Annalist,* July 21, 1919, p. 79; Oct. 20, 1919, p. 493.

5 *Wall Street Journal,* Dec. 4, 1919.

attractive rates, why not shift some of the other investments of the bank, such as acceptances, to the federal reserve banks? or, why not borrow from the federal reserve bank on the security of government obligations? or, why not rediscount notes of customers based on government obligations or arising out of commercial transactions? Any of these methods makes possible an extension of call loans; and, except in a narrow technical sense, it is impossible to deny that the federal reserve bank is not the source of funds loaned on the Stock Exchange. We shall see that probably most of these things have taken place.

In June, 1919, the Federal Reserve Board began to try to check speculation by means of "warnings." A letter was sent to the chairman of each of the federal reserve banks:

Dear Sir—The Federal Reserve Board is concerned over the existing tendency toward excessive speculation, and while ordinarily this could be corrected by an advance in discount rates at the Federal Reserve Banks, it is not practicable to apply this check at this time because of Government financing. By far the larger part of the invested assets of Federal Reserve Banks consists of paper secured by Government obligations, and the board is anxious to get some information on which it can form an estimate as to the extent of member bank borrowings on Government collateral made for purposes other than for carrying customers who have purchased Liberty bonds on account, or other than for purely commercial purposes.

The Board would appreciate your comments on this situation in your district.

Yours very truly,
W. P. G. Harding, Governor.

The facts about the situation since then are presented in tables (pp. 62, 63) compiled from the figures given weekly in the *Annalist* or in the financial columns of the *New York Times*.

In many cases the banks resented the inquiry and cut down the amount of borrowing secured by government obligations. The decrease is seen in the figures in table 1 for the last of June. A more effective check than the warning of the Federal Reserve Board was the withdrawing by the Secretary of the Treasury of a large percentage of the proceeds of the liberty bonds and his failure to deposit in the banks the money received from the income tax.

Table 2 shows that the call rates have ruled high. Undoubtedly, one cause of the high call loan rate has been the policy of the government to absorb, for the purpose of paying expenses, a considerable fraction of the banking resources of the country. This has been accomplished primarily by the sale of treasury cer-

tificates. Then again, the present federal taxes, by concentrating the payments, make it possible, as in the case of the income tax just mentioned, for the government to withhold considerable funds from the market at certain periods.

As was indicated in the board's letter, perhaps the greatest stumbling block in the way of effective control was the vast amount of, and preferential rate on, loans secured by government obligations. Suppose that a business man borrowed to buy bonds of the fourth liberty loan. The bank more or less explicitly agreed to carry the loan for a year at the rate of the bonds and the federal reserve banks felt bound to set a rediscount rate which would make it possible for the member bank to do this. The business

TABLE 1.—CERTAIN ITEMS FROM THE WEEKLY COMBINED STATEMENT OF THE FEDERAL RESERVE BANKS.
(In millions of dollars)

Date	Bills discounted, secured by government war obligations	Bills bought in the open market
1919		
June 6	1,621	198
13	1,696	235
20	1,622	275
27	1,573	305
July 4	1,633	331
11	1,685	360
18	1,580	372
25	1,616	376
Aug. 1	1,613	375
8	1,609	381
15	1,523	374
22	1,563	363
29	1,609	363
Sept. 5	1,635	355
12	1,525	362
19	1,384	354
26	1,573	342
Oct. 3	1,654	327
10	1,673	327
17	1,699	343
24	1,666	369
31	1,681	394
Nov. 7	1,771	434
14	1,700	480
21	1,674	456
28	1,736	496
Dec. 5	1,603	514
12	1,588	542
19	1,415	566
26	1,510	585
1920		
Jan. 2	1,484	575

TABLE 2.—WEEKLY RANGE OF RATES ON CALL LOANS AND WEEKLY AVERAGE RENEWAL RATE FOR CALL LOANS IN NEW YORK.

Week ending	Range (*Per cent*)	Average renewal rate (to nearest hundredth) (*Per cent*)
1919		
June 7	6–5½	6.00
14	12–6	6.00
21	15–5	7.67
28	15–4¾	6.33
July 5	10–5	7.00
12	20–5	7.67
19	12–5½	6.25
26	7–5½	6.50
Aug. 2	20–5	6.33
9	7–3	5.79
16	7–3½	5.58
23	8–3½	4.58
30	6–5½	6.00
Sept. 6	6¼–4½	5.75
13	8–5½	5.79
20	6–4	4.92
27	9–5½	5.90
Oct. 4	15–6	6.17
11	12–6	8.00
18	15–6	8.60
25	8–4	6.00
Nov. 1	20–9	7.50
8	20–2	11.20
15	30–6	14.00
22	12–6	10.33
29	10–6	6.80
Dec. 6	7–5½	6.17
13	15–6	7.17
20	9–5	6.83
27	18–7	9.40
1920		
Jan. 3	25–6	14.40

man has, of course, also borrowed from the bank to meet his business needs, be they commercial or speculative, and this borrowing has been done at the market rate. In the course of time he accumulates funds with which he might pay off the indebtedness on the bonds. However, common prudence would suggest that he pay the loans bearing the higher rate and allow the loans secured by the government obligations, with their preferential rate, to run on. Table 1 shows that the federal reserve banks in general discounted, to the last of November, an increasing amount of bills secured by government obligations and have increased their holdings of bills bought in the open market. The inference is that the banks wished to expend their call loans and have borrowed from the federal reserve banks on the security of government obligations

or rediscounted notes of their customers so secured, also that they have unloaded upon the federal reserve banks many acceptances, which would appear under bills bought in the open market.

The next action came in October, when the Federal Reserve Board asked the New York Federal Bank to send a questionnaire to some of the New York member banks asking them to report, as of October 24, 1919, the amounts of liberty bonds, victory notes, and treasury certificates owned by the institution and the amounts held as collateral, also the rates charged on the loans for which the collateral was held. Then on November 3, 1919, came really the first decisive action: the New York Federal Reserve Bank raised its rates. No longer was it possible to borrow money at 4 per cent on security of bonds paying 4¼ per cent. The other reserve banks followed the lead of New York. The rates were raised again in December.

On November 12, call rates went to 30 per cent, the maximum for the year, and stock prices broke 30 to 60 points in some cases. This and the other high rates in the fall were, obviously, not due entirely to the warnings of the Federal Reserve Board and the increases in the rates of rediscount at the federal reserve banks.[6] The demand for loans is always brisk in the fall, government financing has at times absorbed a large part of the funds of the banks, and the shipping strike tied up funds by hindering the export of goods. So long as the member banks are heavy borrowers at the reserve banks any increase in the rates of rediscount should cause an increase in the rates charged by the member banks, but only in proportion to the increase in the rediscount rate.

Granting that call rates will go up, the effect is not certain, for a surprising feature of the situation has been the slight effect the high rates seem to have had on the volume of speculation. We are accustomed to argue that a high call rate will discourage speculation because it will increase the cost of carrying the stocks. Undoubtedly in many cases this has been true. The present situation differs from the ordinary cases chiefly in the wide and rapid fluctuations in the prices of stocks. These fluctuations present such chances for profit that even a 15 per cent call rate has not discouraged the speculator. Of course, we must remember that the really important call rate is the renewal rate, that is, the rate

[6] *Cf.* the views of the Federal Reserve Board in the *Federal Reserve Bulletin* for December, 1919, pp. 107-9.

which the loans already in existence pay. Frequently the high rates were paid by only a small part of the borrowers.

Since the government has borrowed so much during the war, the provision allowing loans based on government obligations practically destroys the effectiveness of the provision refusing the rediscount privilege to paper the proceeds of which are used in stock speculation. However, the Federal Reserve Board might continue to advance the rate on loans based upon government securities until a penalty differential existed great enough to force borrowers to change the form of their borrowing. Presumably the real test will come when the government ceases to absorb banking funds for fiscal purposes; then the efforts of the Federal Reserve Board to cause deflation will probably meet with opposition and the power of the board, or the lack of it, will be seen.

We may conclude that "warnings" of the Federal Reserve Board, on the whole, seem to be futile. The profit seeking of the banks leads them to go into the business irrespective of the wishes of the Federal Reserve Board. So long as call loans are profitable, banks will use the facilities of the federal reserve banks by presenting securities which the law permits the banks to discount and will use the proceeds for call loans. Raising the rates at the federal reserve banks will raise call rates but may not check speculation at once.

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